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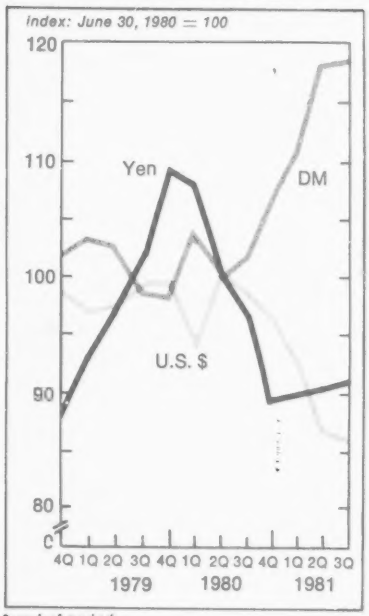
The SDR's Growing Role

Since the redefinition of the Special Drawing Right (SDR) by the International Monetary Fund last January, the simplified five-currency composition has proved much more popular with private markets than the old sixteen-currency version. Indeed, a number of banks and interbank brokers can now handle SDR-denominated transactions, deposits and loans. The chief factor impeding more rapid development of these markets has been the shift of monetary policy in the United States to a stance of stricter control and the consequent resurgence of the dollar's usefulness as an international reserve currency.

Relative value of SDR in terms of selected currencies*



* end of period

Nonetheless, even in a world in which the dollar remains the premier reserve vehicle, SDR-denominated instruments offer attractive characteristics not possessed by other reserve assets. Specifically, in today's environment of highly volatile exchange rates and interest rates, it is imperative that financial managers develop exposure-limiting strategies that take into account the interrelationships between exchange rates and interest rates. Furthermore, since future payments and earnings streams are often highly uncertain, diversified hedges may make more sense than multiple individual hedges. In these circumstances, the SDR can be a useful tool for managing residual exchange-rate and interest-rate risk in one simple strategy. Borrowing (lending) in terms of SDRs reduces the likelihood of a simultaneous increase (decrease) in both the exchange value of and interest rate on the borrowed (placed) unit of account. And having a diversified instrument that is directly tradable offers economies of scale and simplicity of management.

How rapidly the markets for SDR-denominated instruments will grow in the future will depend importantly on the actions of official institutions. Greater activity by official institutions in placing SDR-denominated deposits would be a major boost. So would further official borrowing. Although a few bond issues and syndicated bank borrowings have been arranged, the supply of official debt denominated in SDRs is still very small. A highly significant move in this direction would be the decision of the IMF to tap private credit markets directly and denominate those borrowings in SDRs. The advisability of such a step will apparently be a major item on the agenda of the forthcoming meeting of the IMF's Board of Governors later this month.

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Canadian oil accord may help sustain buoyant growth.

Canada's economic momentum is proceeding at a faster pace than previously expected. Real GNP advanced at a 5.2% annual rate in the second quarter, led by large increases in residential construction and plant/equipment spending. This acceleration followed a 4% real GNP surge in the first three months of the year and is being matched by declines in the rate of inflation and unemployment. The GNP deflator fell to 6.4% in the second quarter, compared with 10.8% in the first. And the unemployment rate dropped to 7% in August from 7.3% in January. A continuation of these trends could be encouraged by the September 1 oil agreement between the Canadian federal government and the Albertan provincial government. Resolving a major internal policy dispute, the agreement provides for higher oil prices and changes in the shares of oil and gas revenues going to Ottawa, Alberta, and the oil industry. The accord has already had positive effects. It has boosted the Canadian dollar exchange rate and heightened expectations of stepped-up oil and gas investment.

Swiss government gives priority to fighting inflation and bolstering franc.

Effective September 2, the Swiss National Bank boosted its discount rate to 6% from 5% and its Lombard rate to 7.5% from 6.5%, the fourth rise this year in these key lending rates. The latest move demonstrates a resolve to maintain a restrictive monetary policy to underpin the Swiss franc exchange rate in the face of rising inflation. In the last three months, the consumer price index has risen at an annual rate of 11.3% and is now 7.4% above its year-ago level. The hike in interest rates coincides with a deteriorating business outlook and indicates the priority accorded to the fight against inflation. Although the next move in short-term interest rates is expected to be downward, the central bank will seek to lag any decline in U.S. and German rates. The monetary authorities recognize that because of the high-interest-rate policy, they will fall short of their 4% annual growth target for the adjusted monetary base.

Belgian authorities aim to stabilize internal and external deficits.

Belgium's internal and external disequilibria continue to worsen. A trade deficit of some $3.3 billion was posted for the first four months of the year, compared with a shortfall of $2.4 billion for the comparable 1980 period. In addition, the central government's budget deficit for 1981 to date is estimated at well above the revised 187-billion franc ($4.7-billion) target, and the public sector's borrowing requirement for all of 1981 is likely to exceed 400 billion francs, rising further in 1982 unless there is a change in policy. Responding to the widening budget and trade deficits, the government has agreed in principle to hold the 1982 public deficit to 200 billion francs through a combination of BF 92 billion in expenditure cuts and BF 44 billion in higher taxes, mainly in the form of increases in several categories of the value-added tax. The measures, if adopted, would hold Belgium's public-sector borrowing requirement to less than 12% of GNP, a figure that is still too high if the planned reduction in the trade deficit is to be accompanied by a revival in private investment.

Dutch authorities seek to cut public deficit.

More than three months after general elections in May, the Netherlands' political parties have reached agreement on a new left-of-center coalition. While details of the new government's economic program have not yet been announced, its overall aim is to reduce the public-sector deficit—expected to reach 8% of national income this year, up from 7.5% last year—and channel public spending away from current expenditure toward investment. Significant reductions in the public-sector deficit, however, will prove difficult in the face of an unemployment rate of nearly 9%, and as long as the foreign markets of the Netherlands' export-dependent economy remain depressed.

Guatemalan economy undermined by political turmoil.

Political turbulence is behind the rapidly deteriorating economic performance in Guatemala. Badly shaken private-sector confidence, substantial capital flight, inadequate care for crops, and stifled trade flows and tourism have dampened economic growth and put pressure on the balance of payments. Real economic

growth was 3% last year, compared with an annual average of 6% from 1977 through 1979. And real GDP will probably be flat or show a decline this year. The 1980 current-account deficit was lower than that of 1979—$170 million versus $206 million—owing to the export strength of sugar, bananas, and nickel. But Guatemala had difficulty financing it, and international reserves dropped to $445 million by the end of last year from $700 million a year earlier. Continued low prices for the country's principal exports and problems in the agricultural sector suggest that the current-account shortfall will expand to some $300 million this year. The overall balance of payments will similarly worsen; international reserves in June were already down to $273 million.

Hong Kong's economic boom may have peaked.

The growing belief that Hong Kong's extended inflationary boom has peaked was further substantiated by a dip in the money supply in July. The decline, reflecting a reduction in bank loans and advances, was manifested in all the monetary measures: M1 fell 1.8%, M2 dropped 1.4%, and M3 narrowed by 3.3%. Other signs of a cooling off of the boom include a softening in the stock market and in real estate prices. The widely followed Hang Seng index, which peaked at 1810 on July 17, was down to 1598 by September 5, while in real estate there have been widespread reports of vacant properties kept off the market to prevent declines. The official consumer price index, however, has yet to decelerate from the 18%+ rate of advance posted for the first half of the year. A cooling down of the economy would be welcome on several counts. It would relieve the pressure on the trade balance, which has registered widening deficits, steady the Hong Kong dollar on the foreign-exchange markets, and ultimately reduce the rate of inflation.

Pakistani external accounts poised for deterioration.

Pakistan turned in a surprisingly good balance-of-payments performance in fiscal 1980-81 (ended June 30). The value of exports increased about 20%, with shipments of raw cotton and small-scale industrial products particularly strong. Imports, previously expected to surge because of the import liberalization measures adopted under the IMF's Extended Fund Facility program, rose only 15%. Despite an increase in the trade deficit to $2.8 billion, the current-account deficit, at $1.1 billion, remained virtually unchanged from its 1979-80 level, owing to a 20% jump in worker remittances. Over the next two years, Pakistan's trade and current-account gaps are likely to widen. With the rupee pegged to the U.S. dollar, Pakistan's exports have become less price competitive because of the dollar's appreciation. At the same time, additional modest measures have been announced to liberalize imports. As a result, the current-account gap is projected to widen to $1.4 billion in 1981-82 and to $1.7 billion in 1982-83. With the strong inflows of aid anticipated, however, such deficits should prove manageable.

International coal trade set for decade of strong growth.

Despite a slowdown in the rate of growth of coal exports this year, the long-term outlook for world coal trade remains bullish. The volume of coal traded internationally in 1981 is expected to show only a modest increase over 1980. A mild winter and advance stockpiling of coal by electric utilities, as well as continued sluggishness in the European steel industry, minimized the net effect of labor disruptions in the United States and Poland—historically the world's largest exporters of coal. An improvement in economic activity in the coming year and continued diversification to coal as a primary energy source by the oil-dependent, coal-resource-poor areas of the world should produce an acceleration in international coal trade in 1982—a trend that is expected to continue throughout the decade. The volume of coal exports is expected to more than double over the course of the 1980s, to a level of over 455 million metric tons per year by 1990, with the United States, Australia, South Africa, and Canada emerging as the major suppliers.

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Aiding the Thrifts

The latest in a series of measures designed to alleviate the problems of the nation's depository institutions will take effect next month. First, savings and loan associations and mutual savings banks will be able to swap their old low-yielding fixed-rate mortgages for more liquid Federal Home Loan Mortgage Corporation (FHLMC) participation certificates, which they may then sell or use as collateral for certain borrowings. Second, banks and thrifts may issue the new "all savers" certificates. The yield on these instruments is pegged at 70% of the current one-year Treasury bill rate, with the first $1,000 ($2,000 for married couples) of interest tax exempt. Unfortunately, neither of these steps offers either a "quick fix" or a cost-effective solution for the problems of troubled institutions.

The financial difficulties of thrift institutions (and some banks as well) stem from unbalanced asset and liability structures. Until recently, thrift structures reflected stringent regulatory constraints. Thrifts' traditional posture of relying heavily upon short-term funds —mostly deposits—to invest in long-term assets—mostly fixed-rate mortgages—left them extremely vulnerable to rises in short-term interest rates. Since deposit rates could not be adjusted promptly to market rates, because of regulation, depositors tended to withdraw their funds to place them in higher-yielding alternatives. The thrifts' chief alternatives to raising consumer deposit interest rates have been greater funding reliance on money-market liabilities with no rate ceilings or the sale of assets—if old mortgages, at a loss. Sizable "carry losses"—i.e., the margin by which funding costs exceed returns on assets—have reduced net worth positions to the point where a number of institutions, according to Federal Home Loan Bank Board (FHLBB) Chairman Richard Pratt, now show an excess of liabilities over assets.

Some industry representatives have characterized this situation as a crisis, which, if not corrected quickly, could lead to widespread failures. Only one institution has actually failed this year, however, and even that was attributed to unsound practices rather than general financing conditions. Indeed, for most institutions liquidity has not been a serious problem, and cash flows, despite negative current earnings, have remained positive. This is largely because most of their interest expense is not withdrawn, but rather becomes new deposits. The increased amount of deposit insurance—to $100,000 per account—enacted in 1980 has undoubtedly been an important factor.

Although liquidity should be sufficient to meet the operating needs of most thrifts for the foreseeable future, regulators realize that reforms are necessary to improve profitability. They have accordingly taken steps to allow these institutions to adapt better to the new economic environment. The deregulation legislation enacted last year provided for a phaseout of all deposit-rate ceilings, allowed thrifts to issue NOW accounts, and authorized increased latitude in consumer and other non-mortgage financing.

Similarly, in 1980, the FHLBB permitted thrifts to shorten the maturity of their assets by sanctioning the issuance of renegotiable and variable-rate mortgages. While these measures will enable thrifts to cope with interest-rate risk in the future, thrift earnings still reflect the impact of their sizable portfolios of old low-yielding fixed-rate mortgages. It is this problem that the most recent regulatory measures address.

The FHLMC plan to swap these old mortgages for participation certificates would not protect thrifts from sizable losses, however, since these mortgages would be sold at their current market value—at a deep discount from their par values. In addition, the maximum amount that the FHLMC is planning to swap ($2 billion this year and $20 billion in 1982) represents only a small percentage of the amount of remaining old mortgages (between $300 and $400 billion yield less than 10%). The all savers certificates, on the other hand, enable thrifts and banks to raise funds at costs well below those incurred on a taxable basis for a comparable maturity. For example, based on the latest Treasury auction, all savers certificates would yield about 12.6%, significantly less than the current 16% rate on six-month money-market certificates. However, at the current rate, and assuming a volume of $100 billion and a marginal tax rate of 40%, they could cost the Treasury (and ultimately the taxpayers) more than $5 billion. Thus, as a subsidy, this plan is little different in principle from other proposals that have been rejected. (The latter include a suggestion that the government buy old mortgages at par.) Furthermore, under a recent plan, the Federal Reserve and Federal Savings and Loan Insurance Corporation (FSLIC) have already agreed to make advances to ailing thrifts at below-market rates.

Some maintain that since many of the regulatory restrictions that caused financial difficulties in the past have now been lifted, thrifts should resolve their current problems themselves. To help in this regard, an accounting rule change would allow the spreading of current losses over several years, thereby encouraging thrifts to sell their old mortgages. In those cases where thrift difficulties have been especially severe and will probably last longer, thrift regulators have encouraged (even contributed financing to) amalgamations; this process will likely expand eventually to include authorization for commercial bank acquisitions of thrifts.

In the final analysis, liberalized accounting rules and expanded amalgamations would be more effective than FHLMC participation certificates and much less costly than all savers certificates. Their main deficiency, of course, is that they would take more time to have a positive impact on profitability. In light of the industry's generally favorable cash flow position, however, further emergency aid does not appear to be necessary.

Carl Alan Batlin

Africa and Middle East Bimonthly Survey of Business and Finance

COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS: 6 months ending	EXPORTS: change from year earlier	GNP IN 1980: in billions of dollars	GNP IN 1980: per capita	BALANCE OF PAYMENTS: latest data	reserves (less gold) in million $	12-month change	months of imports covered	use of IMF credit, millions of dollars	current influences on payments	MONEY AND BANKING: 12-month changes: latest data	consumer prices	money supply(M1) latest data	exchange rate in U.S. dollars September 9, 1981	change from year earlier	current monetary conditions	COUNTRIES
Algeria	Start-up of LNG exports to Panhandle Eastern in United States delayed until November.	May	+ 8%	29.0*	1,525	July	3,338	— 4%	4.2	0	Oil output 867,000 bpd in first half, down 12% from year earlier.	Dec. '79	+ 12%	Dec.	+ 17%	.2275	—13%	Claims on private sector rising steadily.	Algeria
Egypt	Official value of pound devalued from 70 peasters per dollar to 84, effective August 1.	Sept.	+ 53%	16.4*	400	June	677	— 33%	2.9	116	Second stage of Suez Canal expansion to begin in January 1982.	Jan.	+ 17%	May	+ 8%	1.23	—13%	Interest on savings deposits to be raised.	Egypt
Gabon	Non-oil sector expected to lead this year's projected 3% real GDP growth.	June	+ 2%	3.6	6,545	Apr.	211	+469%	3.2	13	Lower oil earnings point to deficit on current account next year.	June	+ 10%	Mar.	+ 12%	.00346	—28%	Credit expansion slows.	Gabon
Kenya	Elimination of sales tax on imported capital goods proposed; import duty to remain.	Dec.	— 6%	6.8	425	June	332	— 42%	2.0	206	External debt service to absorb some 17% of foreign-exchange earnings.	May	+ 9%	Feb.	0	.1235	—12%	Interest rates to continue rising.	Kenya
Liberia	IMF extends $60-million 12-year loan at 6% to help cover 1981-82 deficit.	Dec.	+ 1%	0.7	380	Feb.	15	— 70%	0.3	62	Despite liquidity squeeze, no exchange or profit-repatriation controls applied.	Dec.	+ 9%	Mar.	— 8%	Par	—	Liquidity very tight.	Liberia
Libya	Development outlays slowed by drop in oil export revenues.	Apr.	— 1%	23.0	8,050	May	13,378	+ 41%	18.1	0	Oil output 1.5 million bpd in first half, down 21% from year earlier.	n. a.	—	Dec.'79	+ 33%	3.41	+ 1%	Credit generally available.	Libya
Morocco	World Bank lends $140 million for industrial development.	Mar.	— 4%	15.3*	788	June	123	— 52%	0.4	44	Phosphate exports in first half up 41% from same 1980 period.	Mar.	+ 10%	Mar.	+ 6%	.1880	—29%	Money supply expanding more slowly.	Morocco
Niger	Budgeted 1981 investment below development plan projections.	n. a.	—	2.4	453	Apr.	107	— 10%	4.3	0	Poor uranium price outlook implies reduced export earnings.	Mar.	+ 16%	Sept.	+ 22%	.00346	—28%	Bank borrowing rises sharply.	Niger
Nigeria	New export guarantee scheme (capitalized at 4 mn. naira) to insure risks not previously covered.	Apr.	+ 11%	78.0	1,013	June	8,610	+ 4%	4.7	0	Foreign commercial borrowing up sharply as large current-account gap looms.	Sept.	+ 9%	Dec.	+ 48%	n. a.	—	Fall in foreign reserves tightens liquidity.	Nigeria
South Africa	Projected $3.0-billion budget deficit next year forecloses possibility of tax reductions.	May	— 10%	76.9	2,650	June	737	— 13%	0.4	[illegible]	Value of gold output in first half 21% below year ago.	June	+ 15%	Apr.	+ 51%	1.0475	—21%	Interest rates not expected to fall before mid-1982.	South Africa
Togo	Development program may need scaling down because of export revenue shortfall.	n. a.	—	1.2	470	Apr.	102	+ 35%	n. a.	2	Phosphate sales weak; cocoa and coffee earnings hurt by low prices.	Sept.	+ 16%	Sept.	— 10%	.00346	n. a.	Debt service burdensome despite rescheduling.	Togo
Tunisia	Saudi businessmen to invest $340.5 million in two tourist complexes.	Mar.	+ 37%	7.1*	1,135	June	485	— 24%	1.6	[illegible]	Phosphate rock prices holding steady.	May	+ 7%	May	+ 23%	1.98	—21%	Foreign assets rising steadily.	Tunisia
Zambia	Producer prices boosted 26% to spur agricultural output and revitalize economy.	June	— 8%	3.5	600	May	89	— 8%	0.8	474	U.K.'s ECGD export cover remains suspended as payment backlog persists.	June	+ 13%	Mar.	+ 14%	1.21	— 6%	Agricultural Development Bank prepares to begin operating.	Zambia
Zimbabwe	Increase of 37% in budgeted public spending planned for FY 1981-82; deficit of $120-million projected.	Dec.	+ 14%	4.4	595	Dec.	264	— 6%	2.4	0	Lower gold sales, higher imports shift IQ trade balance to deficit of $42 mn.	Dec.	+ 8%	Dec.	+ 34%	1.51	n. a.	Money supply growth rapid.	Zimbabwe
Kuwait	Budget outlays for 1981-82 put at $10.6 billion, up from $10.3-billion allocation in 1980-81.	Apr.	0	27.3	19,870	July	3,704†	+ 17%	7.5	[illegible]	Oil output 1.1 million bpd in first half, down 30% from year earlier.	Dec.	+ 8%	May	+ 24%	3.5250	— 5%	Dinar bond market reopened with KD 7-mn. issue Aug. 7.	Kuwait
Qatar	Cement output to be expanded fourfold; polyethylene plant to be built at Umm Said.	Apr.	+ 22%	3.2*	15,214	Dec.	343†	+ 19%	2.7	[illegible]	Price of NGL exports to Japan cut from $37.57 per barrel to $34.49.	n. a.	—	Dec.	— 9%	.2775	+ 1%	Credit to private sector continues to increase.	Qatar
Saudi Arabia	Implementation of several petrochemical projects proceeding on schedule.	Apr.	+ 39%	117.6	19,500	July	27,897†	+ 42%	11.8	[illegible]	Oil price held at $32 per barrel; output to be cut by one million bpd.	Dec.	+ 2%	Jan.	+ 9%	.2935	— 2%	Jan. foreign assets were $92.3 bn., up 46% from Jan. '80.	Saudi Arabia
United Arab Emirates	Federal government allocates $3.7 billion for development projects in 1981-85 five year plan.	Apr.	+ 15%	16.0*	19,275	July	2,670†	+ 34%	3.0	[illegible]	LPG exports to Japan from Abu Dhabi Ruwais gas project begun in Aug.	n. a.	—	Apr.	+ 15%	.2735	+ 2%	Industrial Bank to be capitalized at at least $545 million.	United Arab Emirates

Africa

Middle East

*1979

†Excluding state reserves

World Interest Rates

market rates as of Sept. 9, 1981; bond yields as of Sept. 4, 1981

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	14.00 penalty-large banks 18.00	20.69	12.00	13.00	9.50	7.50	19.00 penalty rate 22.00	9.00	6.00	6.25
Day-to-Day Money	16.50 Sept. 10	20.50	12.50	10.90	17.375	12.00	20.125	13.125	7.50	7.4375
Treasury Bills 91-day, Middle Rates	15.30 discount basis	20.25	13.00	15.75	17.83 one-year	n. a.	18.80 79-day	no dealing	no market	5.625 two-month
Commercial Paper prime, 3-month, asked	17.25 finance paper discount basis	21.50 finance paper 15% tax w/h	12.281	12.90 Certified	17.25 Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	16.90	21.30 15% tax w/h	13.1875	12.90 Certified	not traded	9.90	22.30	no market	11.125	no market
Government Bonds Long-term, new and old issues, average yield	15.09	17.50	14.87	10.7787 20% tax w/h	16.87	11.04	21.04	12.57	6.56	8.66
Industrial Bonds prime, long-term, new and old issues, average yield	15.97 Aa Industrials	18.25	16.08	17.02	17.79	11.75	21.26	13.93	6.6312	7.26
Bank Short-Term Rate to Best Borrowers (prime rate)	20.00	22.75	13.50	18.00	18.50	14.50	22.50 ⅛ quar'ly fee on outstdng.	15.50	9.50	6.75
Bank Time Deposits 3-month	17.375 Cert. of Dep.	21.60	13.625	15.50	17.375	12.50	10.75	14.00 large deposits	9.25 residents only	4.25 20% tax w/h
Eurocurrencies 3-month, asked	18.375	no market	13.875	no market	24.50	12.375	no market	14.0625	11.00	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8288	1.7875	.02299	.1725	.4127	.000825	.3729	.4781	.00428
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	2.9175 *D*	4.2741 *P*	2.470 *D*	5.522 *D*	5.7779 *P*	9.2333 *D*	4.5488 *P*	7.1719 *P*	10.4519 *P*

Eurodollar Deposits
(London, interbank, bid)
September 9

7-day	17.25
1-month	16.875
3-month	18.25
6-month	18.50

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	−1.7951
U.S.-Canada Treasury Bills	−0.795
U.S.-Canada Finance Co. Paper	−1.0375
Eurodollars-U.K. Local Auth. Deposits	+0.351

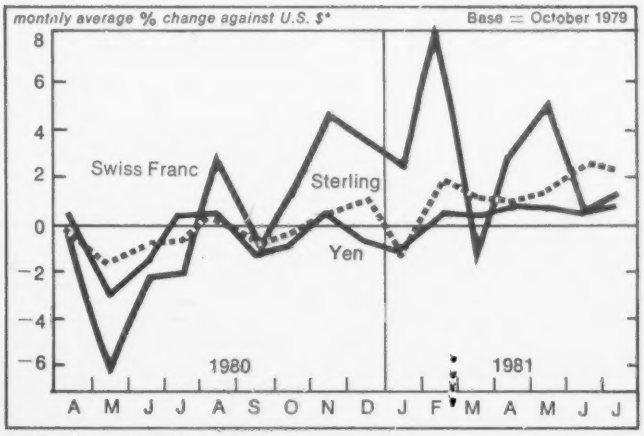
Eurobonds
(average yield on recent straight debt issues)

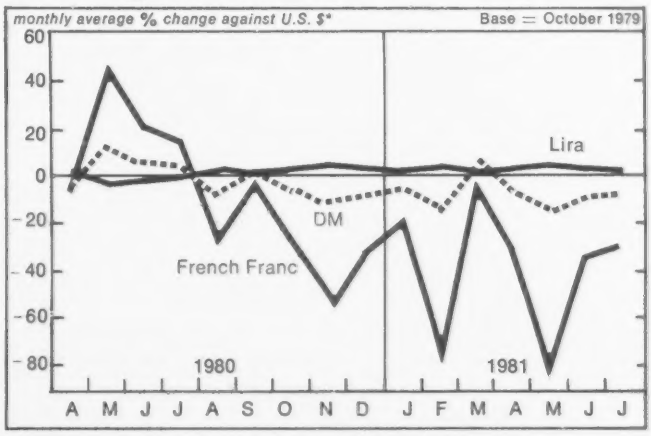
U.S. Dollar Bonds	
7 yrs. and under	17.00
Over 7 yrs.	16.875
DM Bonds	
7 yrs. and under	11.75
Over 7 yrs.	11.25

Gold Price
London afternoon fixing
436.75
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

Movements of major currencies against the dollar





* U.S. dollars per foreign currency unit

Exports Underpin Finland's Economy

Finland's economy has sustained one of the highest growth rates in Europe since 1979, and although momentum is being lost this year, 1981 growth will continue well above the European average. Finnish economic growth, adjusted for inflation, was 7.2% in 1979 and 4.9% in 1980—strong enough to spur an expansion in the volume of fixed investment of nearly 12% last year. Although only little growth is expected through yearend, owing to a slowdown in both the domestic and external sectors, a steep recession is not expected. Indeed, 1981 is likely to post a relatively strong real GDP advance of 2%, thanks largely to the continued strength of exports.

Largely responsible for Finland's export-fueled economic vigor is its unique trade relationship with the Soviet Union (and the Council for Mutual Economic Assistance nations). The USSR, the source of Finland's rising oil imports, has stepped up its demand for Finnish export products sufficiently to offset Finland's higher oil bills. Thus, while the surge in oil prices since 1979 has had the same inflationary impact on Finland as it has had on other OECD countries—keeping the annual rate of inflation in double digits since 1980—it has not had the usual recessionary impact.

External sector cushioned

Finland's protracted trend of rapid export growth (inflation-adjusted export growth over the last five years has averaged 10%) weakened with the start of 1981. While the volume of goods exported increased by 9% in 1980, export growth in the first quarter of 1981 was only 2%, with the total increase for the year projected to remain at about that rate.

Exports have held firm longer than expected in the face of a slight deterioration in price competitiveness and sluggish demand of Western markets. Although exports to market-economy countries slackened during the last half of 1980, exports to CMEA countries rose considerably. The fast growth in such exports, as mentioned earlier, was Finland's response to an enlarged deficit in bilateral trade with the Soviet Union triggered by higher Soviet oil prices. In addition, the start of a new five-year trade agreement with the USSR has helped accelerate exports to the Soviets. Next year, Finnish exports to the West are expected to revive somewhat, so that growth in overall export volume is likely to accelerate further.

Import growth has also eased sharply. Import volume advanced 16% in 1979 and 12% in 1980, but the rapid climb halted in the last quarter of 1980, and import volume declined in the first quarter. The recent sharp import slowdown was partly the result of rauch-reduced energy imports owing to problems in obtaining Polish coal. But weakening domestic demand and output and tight financial markets have been the major causes. Apart from cyclical influences, Finland's intensive energy-saving efforts of recent years and moves to replace imported energy with domestic fuel have led to a permanent decline in energy imports. Last year, despite GDP growth of some 5%, the total volume of energy utilized rose only 1% and energy imports actually decreased slightly.

With exports projected to rise slightly in 1981 (to $14.5 billion from $14.1 billion last year) and imports likely to drop marginally (to $15.5 billion from $15.7 billion in 1980), Finland's $1.6-billion trade deficit last year appears set to narrow to about $1 billion this year. Similarly, the current-account deficit is forecast to decline to $1 billion from $1.34 billion last year—with the invisibles account, traditionally in small surplus, likely to balance.

Sustained domestic sluggishness seen

Finnish private consumption in 1980 increased in line with the growth in households' real disposable incomes—about 2.5% in volume terms. Consumer spending growth both this year and next, however, is expected to slow somewhat because of declines in real disposable income.

The strong growth trend in fixed investment experienced since 1979 is clearly reversing. Last year's 13% investment expansion is expected to be followed by growth of 4%-5% this year, with a small contraction (some 2%) forecast for 1982. Behind this rather steep slowdown are the general weakening of the economy and demand expectations, and the completion of many large investment projects started during the investment boom period. Also, a deterioration in profits and in rates of manufacturing capacity utilization in many sectors implies less willingness by firms to invest. Although the government has taken some measures to stimulate investment—including easing monetary policy, using investment reserves built up during the boom, and shortening the investment tax levy period—the expected downswing in investment is unlikely to be avoided.

Nor will the public sector provide much stimulus. Public spending in 1980 increased by about 3.5%, while public investment climbed 4%, contributing to a public-sector deficit of $1.1 billion (2.2% of GDP). Efforts to limit state borrowing—which totaled $1.3 billion in 1980—and to control the tax burden will limit the growth of public expenditure in the current and in coming years. Much of the decline in public spending will come from public investment, which is expected to remain stagnant in the near future, while public consumption will probably continue to post increases.

Exports Underpin Finland's Economy *(continued from page 7)*

The weakness of demand in both the export and domestic sectors has since the last half of 1980 shown up in declining manufacturing orders, increasing stocks of finished goods, underutilization of production capacity, and reduced profitability. But a sharp recession is precluded. Indeed, the volume of industrial output is expected to continue rising, although at the lower rate of 3%-4% this year and next, compared with expansion rates of 10.5% and 7.1% in 1979 and 1980.

The export sectors will carry the brunt of the recession, particularly the forest industry—where output is forecast to drop 3%-4% this year—and the pulp and paper industry. The anticipated slackening of domestic investment has negative implications for the metal, building-material, and construction industries. Favorable export prospects for the metals and engineering industries, however, will more than offset the falloff in domestic demand in these sectors. Overall, real GDP is projected to increase by 2% both this year and in 1982.

The rapid economic growth of the last few years has expanded employment opportunities, particularly in manufacturing and services, and helped drive down the unemployment rate to 4.8% last year from 7.5% in 1978, despite substantial growth in the labor supply. But this reduced unemployment level is still uncomfortably high, compared with the figures in previous boom periods, owing to structural problems in the labor market. And with the economic outlook promising anemic demand for labor, the rate of unemployment is expected to increase this year to an average of 5%, with the 1982 average forecast at 5.5%. The government has indicated that it will give high priority to reducing unemployment permanently, but labor policy measures to achieve this goal have yet to be announced.

Inflation easing somewhat

Finland's rate of inflation responded sharply to the surge in oil prices in 1979, accelerating to 11.6% in 1980 from 7.5% in 1979. An end to the fast pace of rising prices for imports, domestic products, and building costs, however, came in the closing months of last year. And the rate of consumer price inflation has eased in the current year. Still, prices in April were on average 12.5% above their year-earlier level, and the average rise in the consumer price index for 1981 is forecast at 11%. The reasons for the gradual easing of inflationary pressure are the declines in imported inflation, settlement on a reasonably moderate two-year incomes policy, the favorable pricing policies of the industrial firms—and a slowdown in the growth of the money supply. Expansion of the M2 money stock is estimated at 12% in 1981, down from nearly 15% in 1980 and from more than 17% in 1979.

Policy flexibility afforded

The relative balance in Finland's external accounts provides the Finnish authorities with a good opportunity to even out the recession. Policymakers can focus on stimulating production and employment without the usual concern about aggravating the current-account deficit. Relative to a nominal GDP likely to grow from $50 billion last year to $59 billion in 1982, current-account deficits in the $1-billion range would not constitute a limiting factor for economic policy.

The contents of the 1982 government budget—to be presented to Parliament later this autumn—will set the tone for Finnish economic policy in the near future. Indications are that next year's overall policy stance will be stimulative, funded by $520 million in financial reserves accumulated during the last boom period. The utilization of public investment reserves is scheduled to begin next month. Export and cyclical reserves are expected to be released at the beginning of next year.

Apart from the injection of these reserves, however, fiscal policy's stimulative impact is expected to be small. The authorities are reluctant to use government spending as a cyclical policy tool and are aiming to reduce state borrowing and the continually high level of public expenditure.

Nonetheless, with the weakening of economic output and the abatement of inflationary pressures, the Bank of Finland's monetary policy has moved cautiously in the direction of less restrictiveness. Interest rates on call money and on deposits of cash reserves by commercial banks were reduced this past spring. Moreover, the authorities are willing to allow greater participation by foreign banks in the domestic money market. The easing of monetary policy, however, will not enhance the availability of credit in the short term, as commercial banks are trying to reduce their heavy loans from the Bank of Finland. Consequently, interest rates are expected to remain high.

In sum, the Finnish economy's period of rapid growth has clearly ended, in line with the economic downturns experienced elsewhere in Europe. But Finland's unique trade relationship with the Soviet Union and the policy flexibility its reasonably sound external accounts afford it give the country the opportunity to sustain comparatively high economic growth. In addition, the Finnish authorities' conservative economic management and wage policy imply favorable prospects for reducing inflation and maintaining international competitiveness.

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